1. Can the bundled mass-market service offering be supported by a DOJ/FTC Guidelines approach? Please discuss the supporting information for your analysis.

The *1992 Horizontal Merger Guidelines*, *reprinted* in 4 Trad. Reg. Rep. (CCH), provides the following analytical framework for defining product markets: the government takes the smallest possible grouping of products/services and asks whether a hypothetical monopolist over that product or group of products could profitably impose a "small but significant and nontransitory increase in price." The term "profitably impose" asks whether, in the face of that price increase, enough customers will continue to buy from the monopolist to offset any sales loss to other sellers. So long as the additional profit from the price increase exceeds the profits lost from those customers who turned to substitutes, the price increase would be profitable overall, and the particular grouping of products is deemed to be a separate market for antitrust purposes. 2A Areeda ¶ 533.

Courts have recognized "cluster markets" based on the benefit to customers accruing from the convenience of purchasing complementary products from a single supplier. *United States v. Philadelphia Nat'l Bank*, 374 U.S. 321 (1962) (combination of checking, savings and loan services). The Commission in fact anticipated that a bundle of local and long distance services might constitute a discrete market in the 1997 Bell Atlantic/NYNEX merger order:

> "… we believe that telecommunications services packages that bundle a combination of services may become a separate product market as well. … Once the Bell Companies comply with the requirements of Section 271 of the Communications Act, they will be able to offer both local exchange and exchange access services and in-region long distance services. As both Applicants and other competitors move to offer bundled local exchange and exchange access services and long distance services, consumer expectations and perceptions of the product may also change. We believe that to the extent consumer demand for bundled service packages forces carriers to offer such bundles, the bundling of local exchange and exchange access services with long distance services may well become a relevant product market ..."[1]

Bundled mass-market services constitute a separate market because a hypothetical monopolist can *profitably* impose a small but significant and non-transitory increase in price. Customers will not sufficiently turn to providers of non-bundled *a la carte* services to defeat that price increase. This is so for a number of reasons:

[1] *Applications of NYNEX Corporation Transferor, and Bell Atlantic Corporation Transferee, For Consent to Transfer Control of NYNEX Corporation and Its Subsidiaries*, File No. NSD-L-96-10, Memorandum Opinion and Order (FCC 97-286), Rel. August 14, 1997, at para. 52, footnote omitted.

First, many of the component services of the “all distance” bundles being offered by the BOCs are either not available on an unbundled basis[2] or are offered at such high prices that the BOC could institute a potentially large price increase for the bundle while still pricing it below the *a la carte* services.[3]

Second, a customer’s decision to take a service bundle that includes “unlimited” long distance calling may be motivated by (a) the belief that given the customer’s monthly long distance usage, the plan will be less expensive, and/or (b) the “unlimited” pricing eliminates the risk of an unexpectedly large long distance bill. For these customers, imposing “a small but significant and non-transitory increase in price” vis-à-vis the *a la carte* components would likely be profitable for the hypothetical monopolist, even if it might be cheaper to purchase one of more of the component service in any given month.

Third, the price of the BOC “all distance” offerings bundle is substantially less than the aggregate of the *a la carte* prices of its various components. Imposing “a small but significant and non-transitory increase in price” is more sustainable where the price of the bundle is substantially less than the aggregate of the *a la carte* prices of its various components – which is precisely the case with all of the BOC “all distance” offerings. The discounts do not cut into a carrier’s bottom line because, as CIBC World Markets notes in its recent report on bundling of telecommunications services, “Bundles increase the overall revenue pie, despite offering discounts to “a la carte” prices, as customers buy more services. The winners will be those that expand into new market gain incremental profitable revenue, and offer consumers a package of differentiated and ‘sticky’ products.”[4] Household spending on telecommunications and related services has increased substantially as new products and services – such as cable TV, wireless phones, and the Internet – have become available. Consumers are purchasing *all* of these services, not substituting newer ones for traditional wireline phone service.

As a result of higher costs for customer acquisition, customer care and billing, and access,[5] bundled services can be provided at significantly lower costs than *a la carte* service providers can provide the component parts. Thus, the bundled service provider could sustain a small but significant price increase without reaching the price level of *a la carte* services and triggering *a la carte* substitution for the bundle.

For the reasons set forth in section 4 below, wireline and wireless bundles are not in the same product market.

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[2] Verizon, for example, does not offer an unlimited long distance plan to customers who do not also subscribe to its “all distance” plan, nor does Verizon market or promote the local portion of its “all distance” plan such that a customer would be able to call and order it.

[3] While Verizon’s unlimited interLATA offering in its “all distance” bundle is priced at $15, the least expensive unlimited calling plan we have found that is *not* part of an “all distance” plan is $30 and would not have the advantage of a single bill.

[4] CIBC World Markets, *Opportunities for Flat-rate Pricing and Bundling, Industry Update: Telecommunications Services*, June 26, 2003 (*CIBC Report*), at 1 (provided as Attachment 1).

[5] According to the CIBC Report these costs account for a large part of a carrier’s costs. *CIBC Report*, at 8.

2. Are the BOC bundled mass-market offerings significantly different from bundled offering from AT&T, MCI, etc? Is there any reason that the type of consumer purchasing an AT&T bundled service offering would differ from a consumer that opted for a BOC bundled service plan? If not, please explain your points in Decl. Paras. 46-48.

The ability of the BOCs as compared to competing suppliers to provision and market these service bundles is vastly different.

First, in order to provide bundles of local and long distance service, AT&T and MCI must obtain local service over the BOC network. Unlike the BOCs, which control the local network and merely need to purchase long distance capacity on an already fully competitive wholesale long distance market must obtain the local portion of the bundle from the BOCs. As recognized by the Commission in the Triennial Review, self-deployment of key local network facilities is, in the vast majority of circumstances, uneconomic for CLECs because of enormous entry barriers.[6] Thus BOC competitors seeking to offer bundled service face the type of discrimination, price squeezes and cost misallocation demonstrated by the various Consent Decrees entered against the BOCs for discriminatory access and the record developed in this and the *Section 272 Sunset*[7] proceedings.[8]

Second, BOCs are the dominant local exchange carriers within their respective service footprints, and as such maintain an existing relationship with the overwhelming majority of customers (approximately 90%) within their operating areas. The overwhelming majority of customer-initiated ("inbound") contacts with LECs are to the BOCs, who then have "first access" to the customer with respect to his/her choice of Primary Interexchange Carrier ("PIC"), and are able to exploit this inbound marketing contact to sell its "all distance" bundle. Customers desiring to establish new local telephone service will typically contact the LEC first, and will make their PIC selection during that contact. Thus, non-BOC providers of both the bundle and *a la carte* services

[6] *See, e.g.*, News Release, *FCC Adopts For Network Unbundling Obligations Of Incumbent Local Phone Carriers* (Feb. 20, 2003); *Triennial Review Order* ¶¶ 225-226, 298; *UNE Remand Order* ¶ 182("self-provisioning is not a viable alternative because replicat[ion of] an incumbent's vast and ubiquitous network would be prohibitively expensive and delay competitive entry"). *Cf. Twombly et al v. Bell Atlantic et al*, D.S.D.N.Y. No. 02 Civ. 10220(GEL), Oct. 8, 2003, at 10 ("Because the nature of telecommunications networks is such that for a competitor to build a duplicate infrastructure in a particular territory would be prohibitively expensive and create precisely the inefficiencies that telecommunications regulation has always sought to avoid, § 251 conceives of CLECs as working on a different business model. CLECs do not maintain their own infrastructure, instead "obtain[ing] access to an incumbent's network." *Iowa Utils. Bd., 524 U.S. at 371-72.* Thus, a CLEC's business is completely dependent on its relationship with the local ILEC. … The extent to which they must depend on the relevant ILEC is demonstrated by plaintiffs' allegations as to the ILECs' wrongdoing with respect to CLECs, including that "[d]efendants [ILECs] … have failed to provide access to their operational support systems… on a nondiscriminatory basis that places competitors at parity." (Am. Compl. Para. 47). Thus, the extent to which competing as a CLEC is profitable will depend in substantial part on the terms that can be negotiated with the ILEC, whether the relationship is successful or dispute ridden, and whether the ILEC fulfills its obligations under § 251").

[7] WC Docket No. 02-112. *See* AT&T 272 Sunset Comments at 21-44.

[8] *See id.*

must engage in extensive and expensive advertising campaigns to stimulate inbound customer contacts.

From a cost perspective, out-of-pocket costs arising from the required purchase of a UNE-P (or other underlying facilities) by the CLEC, together with the costs of marketing and advertising these bundles, represent a far greater portion of the retail price than the BOC's out-of-pocket costs associated with the (largely resold) long distance services that are included in the BOC bundles. Hence, all else being equal, the BOCs are able to realize a much larger operating margin on their bundled services than a CLEC, even if the two services carry the identical price. The RBOCs' cost and marketing advantages in offering bundles has been noted by financial markets. The CIBC report concluded that "it will be much easier for companies with dominant local franchises to bundle and create differentiated products, than it will be for other companies from other segments of the consumer market," and that "the RBOCs have a competitive advantage with their ability to offer unique bundled in a cost-effective manner." The relevant pages of the report are appended hereto.[9] CIBC discounted the significance of other competitors such as the IXCs, and wireless: "[w]e believe that even if RBOCs' competitors can assemble a comparable bundle, their costs would be substantially higher, and the strength of their balance sheets may limit the competitive response." Long-distance companies were discounted both because they "only have the ability to sell local-exchange services in a cost effective way to half of the country, and we expect this to shrink over the next five years" and "[m]ore importantly, the long-distance carriers have limited abilities to bundle broadband, wireless and second phone lines, let alone create unique applications." Wireless companies were discounted because they "only have one component of the bundle, with very limited capabilities to add other pieces, and we expect them to remain niche players in the overall consumer market."

Although the BOC is subject to access charge imputation requirements under Section 272(e)(3) that remain in force with respect to the then-integrated BOC ILEC/LD entity following the sunset of the Sec. 272(a) separate affiliate requirement, enforcement of the imputation requirement has been, to date, ineffective in protecting rivals who must interconnect with the BOC's network from being subjected to a price squeeze by the BOC.[10] The difficulty in addressing and enforcing imputation can only increase once the nominal "purchase" of access services by the separate LD affiliate no longer takes place.

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[9] *CIBC Report*, at 12-13.

[10] In many jurisdictions including interstate, the "access charge imputation" requirement has been interpreted as requiring only that the BOC ILEC and/or its LD affiliate set their retail long distance rates *no less than* the underlying access charges, without considering any additional network or retailing costs. *See* 47 U.S.C. §272(e)(3), as applied by *Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No 96-150, *Report and Order* (FCC 96-490), Rel. December 24, 1996, at para. 86-87; 4 CCR 723-30-2.18. If the BOC ILEC's or affiliate's retail LD price is set equal to the access charges paid by rival nonaffiliated IXCs thereby forcing the IXC to match the BOC's pricing, the IXC would then have no ability to compete profitably; indeed, even if the IXC's network and retailing costs were *zero,* which they obviously are not, an attempt to match the BOC's pricing would eviscerate any potential profit. Even where a state "imputation test" includes the additional network and retailing costs, BOCs have argued that they should be allowed to satisfy the imputation requirement only in aggregate across all toll or long distance services, pricing some below cost (e.g., discounted toll plans and service bundles) while recovering the shortfall through above-cost pricing of by-

Since the BOC's long distance business unit is wholly owned and given the ineffectiveness to date, of FCC and state imputation requirements, for all practical purposes the values at which any internal transactions are recorded on the BOC books are immaterial. In that regard, BOC long distance business avoids the out-of-pocket access payments that IXCs and CLECs are required to pay to the BOC. Frequently these access charge payments are avoided on *both* the originating and terminating end of long distance calls, since a large percentage of calls both originate and terminate within the same RBOC's footprint. CIBC noted this BOC advantage and the unique financial benefit it affords the RBOCs with respect to their flat-rate calling plans:

> "Historically, consumers have liked the certainty of flat rate pricing in the communications market and they ability to use as much as they like, but investors may be concerned with the costs for such products. We believe the long distance experience is illustrative. The RBOCs can now buy long-distance services for $0.005 per minute including terminating access. Half of all calls, though, originate and terminate in-region, *so the actual cost per minute is $0.003* versus revenue that is still in the 0.8 cents per minute range."[11]

Unlike the BOCs, CLECs offering bundled packages will almost always be required to make out-of-pocket access charge payments to an ILEC at the terminating end of the call.

These formidable advantages give the BOC the ability to offer the same bundle of services to a customer at a substantially lower cost than competing IXCs and CLECs. Paras. 46-49 of the Selwyn Declaration describe how Verizon's bundled local/long-distance "Freedom" offering provides unlimited interLATA calling at average prices that are far below intrastate switched access rates. Because of their small local service market shares, IXCs must generally pay terminating access to the local service provider terminating the long distance call. With their huge local service market shares, BOCs are much more likely to be both the originating *and* the terminating service provider and thus much more likely to avoid the payment of access charges for intrastate calls. (*See* Selwyn Dec. para. 48, n. 63.)

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the-call services. AT&T filed a formal complaint addressing such practices by (then) Bell Atlantic-New Jersey in 1997, a matter that remains unresolved to this day. *I/M/O Petition of AT&T Communications of New Jersey, Inc. for Determination of Compliance By Bell Atlantic–New Jersey, Inc.'s Selective Calling and Intramunicipal Calling Services with Imputation Requirements*, NJ BPU Docket No. TO97100808 (Rebuttal Testimony of Dr. Lee Selwyn in this proceeding is provided as Attachment 2). AT&T is not aware of *any* action by a state commission or by the FCC with respect to BOC ILEC/affiliate pricing of local/long distance bundles. As discussed at paras. 84-86 of the Selwyn declaration, the incremental price of the toll or long distance component of such "bundles" is often quite small, in some cases actually *negative*.

[11] *CIBC Report*, at 20. Emphasis supplied.

3. What types of marketing efforts does AT&T engage in for local service and bundled service offering? Please describe any initial evidence of reduction in customer acquisition from implementation of National Do Not Call Registry.

AT&T uses a range of marketing channels for local service and bundled offerings, particularly telemarketing and direct mail. The National Do Not Call Registry has become effective too recently to allow the collection of evidence regarding its effect on customer acquisition. However, telemarketing is AT&T's most productive marketing channel and AT&T therefore expects to be affected.

The National Do Not Call Registry clearly will have a much greater effect in limiting telemarketing by IXCs than by the BOCs. Because of the exemption for current and recent customers, the BOCs may telemarket long-distance and bundled services to their existing local service customers, and make "win-back" marketing calls to recently-lost local service customers, unaffected by this restriction. Consequently, the BOCs can make outbound marketing calls to approximately 90 percent of their potential in-region customers for long distance and bundled services. In contrast, because no IXC has a long-distance market share over 30-40 percent, IXCs are prevented by "do not call" restrictions from making outbound marketing calls to the large majority of their potential customers for local service and bundled offerings.

4. How should the Commission account for the impact of wireless service on our analysis of the mass-market? AT&T SEC filings attribute long distance minutes loss to wireless. Why wouldn't price increase in long distance rates or an increase in the price of the bundled offering lead to migration of more minutes to wireless offerings (and a subsequent termination of the bundled package)?

a. Elasticity of substitution – The Selwyn Declaration refers to estimates for demand elasticity for intraLATA calling from two Qwest state proceedings to draw conclusions regarding the impact of wireless on interLATA call. Please describe any other similar evidence you are aware of. (Reply Decl. Paras. 39-42).

The Selwyn Reply Declaration at paragraphs 39-42 discusses own-price elasticity claims by Qwest in two recent cases before state regulatory commissions. Dr. Selwyn does not claim that there is not some level of substitution between wireline and wireless long distance services (*see* Reply Decl. at 39). However, the Commission should consider BOC claims of rampant wireless substitution in light of contradicting claims by Qwest (and other RBOCS) before state commissions.

In Decision 98-07-033, the California Public Utilities Commission found that intraLATA toll demand is highly price-inelastic. The Commission, while recognizing both that elasticity is neither static nor easily measured, nevertheless adopted Pacific Bell's estimate of -0.20 for intrastate toll price elasticity.[12]

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[12] *Re: Pacific Bell*, Application 97-03-004, Decision 98-07-033, July 2, 1998, 1998 Cal. PUC LEXIS 570, at *85.

b. Please provide an analysis for substitutability between an all-distance local/long distance package and an all-distance wireless package.

The substitutability between an all-distance wireline and an all-distance wireless package must be considered in terms of the substitutability and marginal price of component parts. In addressing the question of wireline/wireless substitution, it is useful to think of these services as each satisfying two distinctly different functions – (1) the ability to *originate* outbound calls, and (2) the ability to *receive* incoming calls.

With respect to both inbound and outbound calling, wireless bundles do not impose any pricing constraint on wireline bundled pricing plans and its component parts, at least with respect to households comprised of more than one person. That is because wireless phones are typically used by specific individuals, while wireline phones (and local and long distance wireline bundles) typically serve an entire "household" rather than a single individual user. Thus there must be one wireless phone per person in the household in order to replace wireline service. Otherwise a household member is stranded when the possessor of the phone takes the phone with him or her in order to obtain the benefits of mobility, which is the primary benefit of the wireless phone.

Thus, to compare (roughly) equivalent wireless and wireline packages, one would need to compare the total price of a wireline bundle with the total price of a "family" multi-phone wireless package. So-called "family" wireless packages provide multiple phones, each with its own phone number, and a "pool" of daytime minutes that are "shared" among all of the phones in the group.[13] Attachment 4 hereto is an example of a monthly bill from Verizon Wireless for a 3-phone family package, with the total monthly charge of $126.77. Unlike "all distance" wireline bundles that offer *unlimited* local and long distance calling 24/7, most "family" wireless plans provide a finite allowance of daytime minutes that can be used for local or long distance. Calls placed in excess of the monthly allowance are charged on a per-minute basis; in this example, the charge for each additional daytime minute is 45 cents. Typically, the "marginal" additional airtime charge is many multiples of the wireline long distance per-minute rate of 5 to 10 cents (in measured-use calling plans) and similarly well in excess of the *effective* per-minute price under unlimited "all distance" plans. Consequently, the ILEC would be able to effect "a small but significant and non-transitory increase in price without shifting demand to other products."

Outbound calling. The principal considerations relating to outbound calling are price and quality. In addition to the need to have one cellphone per family member in order not to leave the others stranded, there is a need for multi-room and multi-floor dwellings, the ability to have several extension phones on a single wireline service, and/or the ability to have several family members participate on the same call (via extension phones) increases the utility of wireline service vis-à-vis wireless. Except for the "unlimited night/weekend calling" that applies in some wireless pricing plans, all usage is either counted within the monthly calling allowance or is subject to a per-minute

[13] Information from the Verizon Wireless website regarding family wireless plans is contained in Attachment 3 hereto.

charge. Thus, even toll-free 800-type calls would be "chargeable" in typical wireless pricing plans.

Inbound calling. The ability to have multiple extensions on a single wireline service may be far more important for inbound calls than for outbound calls. Census Bureau data indicate that 68% of all US residences involve multiple floors. If the single wireless phone is not convenient to the user at the time than an inbound call arrives, the ringing signal may not be heard, and the call may not be answered in time even if it is heard. Customers who select premium-priced "all distance" bundles exhibit a particularly high level of concern about incoming calls, since BOC "all distance" bundles typically include call waiting, caller ID, call waiting with caller ID, voice mail, call return ("*69") and call forwarding, *features that relate solely to inbound calling*. While these features are also offered in most wireless service plans, their utility is limited to the specific user of the wireless phone, rather than the entire household. Additionally, most wireless pricing plans in the US charge for incoming calls (either as part of the monthly calling allowance or on a per-minute basis if the allowance is exceeded), which confronts the user with a usage-sensitive price for most incoming calls. Wireline services generally do not charge the customer for incoming calls.

Wireless service is not a close substitute for wireline service in multi-person households. 41% of American households contain three or more persons. If a "family" wireless plan (involving multiple phones each with its own phone number) were to be substituted for wireline service, the household would then have no single phone number – *i.e.*, no single point of contact. If the household subscribed to only a single wireless phone, there would be times when the phone is not at the residence at all, impairing the ability of other household members to place or to receive phone calls.

Yet-to-be-resolved technical issues also limit a household's ability to substitute wireless for wireline. Cellular phones are powered by rechargeable batteries, many of which have a maximum talk time of only an hour or two, as well as a standby battery life that degenerates significantly over time. Additionally, the reliability of cell phone E911 technology, which depends, in part, upon Global Positioning System ("GPS") satellites, is yet to be demonstrated, and in any event does not exist at the present time.

For all of these reasons, wireless bundles are a poor substitute for wireline as a means for satisfying a household's telephone service needs. Households are therefore likely to retain wireline local service for incoming and local calling purposes, even if they choose to make long distance calls on their wireless phones.[14] And if the "shared" monthly usage allowance for the "family" wireless plan has been exceeded, additional

[14] This conclusion is supported by the Census Bureau's September 2001 Computer and Internet Use survey (containing questions regarding wireline phone service). The data indicated that only .11% of survey respondents reported replacing home phone lines with wireless phones. Bureau of Labor Statistics, United States Department of Labor; Bureau of the Census, United States Department of Commerce, Current Population Survey, Computer and Internet Use Supplement, September 2001. Available at http://www.bls.census.gov/cps/ (accessed November 19, 2003).

airtime charges will apply, thereby making the wireless long distance call more expensive than the corresponding call if placed from the customer's wireline phone.

While there has been much coverage in popular media regarding customers who discontinue their wireline service altogether and substitute wireless, in reality this represents an extremely small percentage of households and is in no sense a mainstream phenomenon. Customers who are most likely to purchase *wireline* "all distance" plans are probably the *least likely* to substitute wireless services for their wireline bundle. Moreover, to the extent that such customers would ordinarily purchase the various calling features that are typically included in the wireline bundles, the *incremental price* of unlimited long distance calling is relatively low. Consequently, there is no basis to assume that there is any consequential elasticity of substitution between wireline bundles and wireless services. BOCs can thus increase the overall price of the "all distance" bundles by increasing the price of the calling feature elements, while holding the unlimited long distance price differential constant. Wireless services will not work to constrain the BOCs' prices for "all distance" bundles.

c. What will be the impact of wireless LNP requirement on the substitutability of wireless and wireline?

With respect to substitution, the availability of wireline-to-wireless number portability might conceivably make it somewhat easier for a customer to discontinue wireline service and utilize wireless as the primary telephone. However, for the reasons discussed in response to 4(b), there are numerous reasons why wireless is not a satisfactory substitute for wireline service, and the availability of LNP would not materially change that situation. For example, in a multi-person household that has several wireless phones, to which of those wireless phones would the wireline number be ported? Obviously, if calls to that number were directed to any member of the household, porting the wireline number to one of the household's wireless phones would not be satisfactory.

That LNP is not likely to significantly increase substitutability can be inferred from the behavior of those persons who have no vested interest in their wireline number. Roughly 17% of US households move each year, typically requiring a new telephone number. LNP would not be an issue if, at the time of the move, the customer were simply not to order wireline service and utilize only his/her wireless phone. Nevertheless, the vast majority of customers in such instances do install a wireline phone in addition to their wireless service.

The Commission has recently acknowledged additional reasons for this lack of substitutability in the TRO, "…the record demonstrates that, although promising, wireless CMRS connections in general do not yet equal traditional landline local loops in their quality, their ability to handle data traffic, and their ubiquity"(at para 230).

5. Inbound marketing—The Selwyn Declaration points to a U.S. Postal service relocation flyer listing a BOC as a local service carrier. Can competitive carriers potentially be added to such a list as a LEC? (AT&T is listed at the bottom of the page for LD).

The U.S. Postal Service flyer was included with the Selwyn Declaration to demonstrate that the BOCs continue to be portrayed and perceived as being *the* telephone company. Dr. Selwyn does not know what criteria are used by the USPS in deciding which LECs are to be listed in this brochure or if it is possible for a CLEC to be added to the flyer as a local service provider. However, the fact that nearly eight years after the passage of the 1996 Act the ILEC is still the only local service provider in the USPS list indicates that CLECs have had little success in modifying consumer perceptions as to who provides local telephone service.

A recent study by the National Regulatory Research Institute ("NRRI") found that less than 50% of customers, even in states with early Section 271 approval, knew that they were able to choose their local exchange provider.[15]

6. Please explain why BOC interLATA share is a lower bound than its intraLATA share? In the Selwyn Declaration, it notes that it is inconceivable that a customer would select a BOC for interLATA service while choosing a non-BOC carrier for intraLATA calling.

The BOCs already had a substantial base of intraLATA toll customers prior to obtaining section 271 authority. Before their interLATA entry and prior to 1+ intraLATA equal access (which generally occurred in about 1999), the BOCs were the default provider of intraLATA toll service. Moreover, at the time that 1+ intraLATA presubscription was implemented (and unlike the case of interLATA 1+ that was implemented in the mid- to late-1980s), customers were not offered a "ballot" on which to select their intraLATA PIC. As a result, the BOC ILECs continue to retain a substantial base of legacy intraLATA toll customers.

Customers are permitted to specify separate and different intraLATA and interLATA PICs. However, the typical manner in which long distance service is being marketed (by the BOCs as well as by nonaffiliated IXCs) involves encouraging customers to switch their intraLATA PIC to the same long distance carrier. Customers are afforded the opportunity – and are encouraged – to change their intraLATA PIC to the LD carrier. While it is theoretically possible that a customer could specify an intraLATA PIC and a different interLATA PIC neither of which were the BOC ILEC entity itself, the overwhelmingly likely case is that the intraLATA PIC will be *either* the ILEC or the interLATA IXC. Additionally, long distance price plans typically embrace both intraLATA and interLATA calling, and provide customers with an economic incentive to select the same IXC for both. (*See also*, AT&T Reply Comments at 25-26 & Farber Decl.)

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[15] National Regulatory Research Institute, *Press Release: Consumers Often Unaware They Can Choose a Local Telephone Company*, May 1, 2003. Provided herewith as Attachment 5.

Thus, some portion of the BOC LD's interLATA subscribers will continue to specify the BOC ILEC as their intraLATA PIC, but it is almost inconceivable that a subscriber would specify the BOC LD affiliate as the intraLATA PIC while selecting a nonaffiliated IXC for interLATA service. The BOC LD affiliate's intraLATA share will thus never exceed its interLATA share.

Importantly, when a BOC LD affiliate does convince a BOC ILEC subscriber to migrate his/her intraLATA PIC to the LD entity, the effect is to divert revenue away from the BOC ILEC. If the BOC ILEC is subject to rate of return regulation, this will have the effect of eroding its (apparent) earnings, which could then be used as a basis to support an application for a general rate increase. If the BOC ILEC is subject to price cap regulation, the diversion of intraLATA output to the affiliate will create an apparent decrease in the rate of productivity growth, which could similarly be used as a basis for a readjustment to the productivity offset (X) factor.

7. What impact will bundling of local/LD/wireless have on BOCs out-of-region? If this bundle becomes an important offering, will this prompt Verizon Wireless, by example, to bundle local/LD with its wireless services out-of-region?

BOCs are not currently providing local, long distance and wireless bundles outside their regions, and it is unlikely that the BOCs will enter the out-of-region local markets in order to protect their wireless share. BOC Wireless affiliate shares are concentrated in the BOC in-region areas.

Bundling of local and wireless services is currently being offered by Verizon under its "Verizon Freedom" brand, but Verizon indicates that a customer signing up with "Verizon Freedom All" must "sign-up for a *new* account with Verizon Wireless" and therefore apparently limiting the bundled package savings to only new Verizon Wireless customers.[16]

8. What is the impact in the market if carriers do not include a call detail listing in bills for consumers that opt for a bundled service offering that includes unlimited toll calling?

As noted in response to question (1) *supra*, a customer's decision to take a service bundle that includes "unlimited" long distance calling may be motivated by (a) the belief that given the customer's monthly long distance usage, the plan will be less expensive, and/or (b) the "unlimited" pricing eliminates the risk of an unexpectedly large long distance bill. To the extent that some or all of the customer's motivation was for reason (a), the customer will want to periodically reevaluated that choice in relation to his then-current usage levels. However, some carriers do not include call detail in their billing for "unlimited" long distance calling plans. Where this is the case, the customer must devise

[16] See, http://www22.verizon.com/foryourhome/sas/ProdDesc.asp?ID=10006&NPA=&NXX=&CategoryID=301&state=MA, accessed November 25, 2003.

some other means for at least estimating monthly usage in order to determine whether the unlimited calling plan is beneficial vis-à-vis by-the-call or other measured-use pricing.

The absence of call detail further differentiates bundled from *a la carte* services. Customers who are particularly risk-averse may be willing to pay a premium for certainty and forego the call detail, whereas those less willing to pay a premium to avoid such risk and who otherwise are unsure as to their actual usage levels may opt for measured-use pricing, at least until they are able to determine, based upon the detail billing that they will then receive, that they would save under the flat-rate arrangement. Certainly the absence of call detail makes it more difficult for a consumer to determine whether it would be more economically rational for that consumer to purchase services *a la carte* rather than as part of a bundle.

9. What would be an appropriate remedy for AT&T's assertion that expanded calling areas are only available if customers opt for Verizon as their interLATA [sic] PIC. Do the states address this concern? (Selwyn Decl. para. 71-73).

We assume that the reference should be to "intraLATA PIC," since that is the point in the referenced paragraphs of the Selwyn declaration. As noted in response to question (2), at footnote 10, this matter has been before the New Jersey Board of Public Utilities (NJ BPU) since late 1997 and remains unresolved.[17] AT&T is not aware that the matter has been specifically addressed in Massachusetts or elsewhere. The BOCs' ability to offer these pseudo-local (but actually toll) services on a flat-rate basis arises directly from the fact that the BOCs incur no out-of-pocket access charges. Competitors obviously cannot do so.

10. Please explain your points at Selwyn Decl. paras. 91-3 further. Is the primary concern the allocation of jointly used network facilities and organizational resources?

The primary concern expressed at paras. 91-93 is the incremental pricing of interLATA service by the BOCs. The enormous amount of joint costs involved in the provision of local and long distance service allow the BOCs to allocate the vast majority of joint costs to the BOC's local operations, while charging long distance operations only the incremental costs. This allocation scheme effectively ensures that all economies of scope realized by the BOC are reflected in the results of long distance operations.

Many joint costs BOCs face are results of their legacy local monopoly. The BOCs have preexisting local customer relationships with virtually all customers in-region, they are able to provide long distance services at a lower incremental cost than stand-alone IXCs. BOCs, for example, already send a bill to the home of all in-region local customers, and including long distance charges on that bill represents little incremental billing and collection cost to the BOC. Since imputation requirements are

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[17] *I/M/O Petition of AT&T Communications of New Jersey, Inc. for Determination of Compliance By Bell Atlantic–New Jersey, Inc.'s Selective Calling and Intramunicipal Calling Services with Imputation Requirements*, NJ BPU Docket No. TO97100808.

generally limited to access charges, they often do not address other, non-access (and typically non-tariffed) services that are furnished by the ILEC entity. Once the separate affiliate requirement sunsets, the requirement for Sec. 272(b)(5) disclosures will no longer exist, making it nearly impossible to identify the costs or values associated with non-access activities that the BOC ILEC performs on behalf of its (now integrated) long distance operations. The BOC will not be forced to disclose what proportion (if any) of a joint billing costs are being charged to long distance operations.

As a direct consequence of the BOCs' ubiquity with respect to *local* mass market services, it obtains numerous marketing advantages over its nonaffiliated rivals that go well beyond the mere potential for misallocation of costs. BOCs are perceived as "the phone company" and are typically the first point of contact by a customer to arrange for new local telephone service. This provides the BOCs with a sort of "first mover" advantage that makes the "referral" of the local customer to the long distance business unit (separated or integrated) even more valuable than the mere cost that a rival would incur in contacting the same customer. According to the BOC Sec. 272(b)(5) disclosures, however, the joint marketing "cost" that is being assigned (charged) to the LD affiliate is typically based upon the labor costs incurred, with no allocation of the value of the customer contact itself.

As another example, the national do-not-call list does not prevent BOCs from initiating telemarketing calls to existing local customers for purposes of selling long distance service. Nonaffiliated IXCs may not initiate such calls if the prospective customer has placed his or her number on the do-not-call list.

We are not aware that the BOCs have made any Sec. 272(b)(5) disclosures or have otherwise allocated any costs to the LD operation for the use of the BOC's local customer basis as a source of telemarketing contacts. The unique value to the BOC's LD operations of this customer list is not sufficiently addressed by mere cost allocation.

11. Selwyn states that cost misallocation is an issue with price cap regulation because states re-examine costs. (Selwyn paras. 97-98). Has this already occurred anywhere? Can this issue be resolved at the state level and if not, why?

The re-evaluation of state price cap plans is common. State Commissions have in recent years reviewed price cap plans in Illinois, Massachusetts, Connecticut and Kansas and are currently reviewing price cap plans in Alabama, California, Idaho, Maryland, and New Jersey. Arizona, Colorado, and Oklahoma are scheduled to review their price cap plans in 2004. In addition to these periodic reviews, ILECs have requested and been granted "ad hoc" adjustments to their price caps. In California, for example, Pacific Bell requested and was granted permission to increase its directory assistance rate. These reviews frequently involve examination of earnings under price caps, realized productivity growth, and other elements that would be directly affected by a misallocation of BOC LD costs to the BOC ILEC entity.

Where a BOC is subject to price cap or another form of incentive-based regulation under which its earnings are not constrained, misallocation of costs to core regulated services will conceal potentially excessive earnings, a condition that might lead regulators to revise the parameters of the price adjustment mechanism (e.g., the X-factor) or perhaps even reinitialize rates periodically to produce no more than the "authorized" rate of return. *No* state PUC price cap plan of which we are aware has established an X-factor even remotely close to the 6.5% last adopted by the FCC, which was itself expressly based upon *total company unseparated results,* i.e., specifically *not* interstate-only productivity. Hence, any state price cap plan with an X-factor less than 6.5% will result in excessive earnings. The fact that many BOCs report intrastate RORs below the interstate levels serves only to confirm the likely effectiveness of their cost-shifting efforts. An appropriately set X-factor would, in theory, discipline the BOCs sufficiently so as to avoid their reporting excessive returns.

This ability to engage in cost-shifting supports predatory pricing, by permitting the BOC to shift profits from its competitive services to those for which no present rivals exist. Moreover, to the extent that costs are misallocated to monopoly services that are used as inputs by RBOC rivals (*e.g*., access services, UNEs), the RBOC is able simultaneously to engage in predation while raising its competitors' costs. The RBOCs' practices with respect to the pricing of bundles of local and long distance services is entirely consistent with this type of conduct.

12. Explain how the creation of an all distance bundle easily overcomes price cap limitations (Selwyn para. 99).

All distance bundles, like other putatively "competitive" services, are not typically subject to a price cap under most state price cap plans. See full discussion at para. 99.

13. What is the value of the cost allocation methodology if consumers move to an all communications framework, i.e., consumers select a single carrier for all their communications needs (regardless of whether customers take a bundle or not).

In a world in which all segments of the telecommunications industry were subject to effective, price-constraining competition (a world that does not presently exist), cost allocation among the various services would not be necessary, because marketplace forces would work to correct a misallocation by any one firm. If one firm (firm A) were to over-allocate costs to a particular service category (*e.g*., local), rival firms would bid down the market price, forcing firm A to correct the misallocation. In the case of "bundles" of several individual services, the prices of such "bundles" would come to reflect the aggregate of the *a la carte* prices of the components, less a "discount" reflective of any economies of scope/scale arising through the bundled offering (*e.g*., savings in billing and collection costs).

In the instant case, however, the BOCs hold a decisively dominant position in the local market and maintain extensive market power with respect to local services. By overallocating costs to local (and thereby underallocating costs to toll), the BOC is able to place non-integrated rivals in a price squeeze with respect to toll service, while not themselves suffering any short-term economic loss, since the revenues that might have come from toll are merely shifted over to the (monopoly) local service. This will be the case even if all or most consumers select a single provider for all services and purchase bundles from that carrier. BOCs will continue to control access to their local network and to network resources and, depending upon the outcome of the TRO-initiated state "impairment" proceedings, may even be relieved of their obligation to provide certain UNEs. The combined effect of excessive UNE prices and correspondingly predatory long distance prices would make it extremely difficult for rivals to compete with the BOC for bundled services.

14. How applicable is the model envisioned by Bolton et al to this industry? (Selwyn Reply Decl. paras. 61-67).

Bolton provides specific illustrations of predatory conduct by Bell telephone companies. See, for example, Attachment 6, an extract taken from Bolton, Patrick; Brodley, Joseph; Riordan, Michael, *Predatory Pricing: Strategic Theory and Legal Policy*, Available at: http://www.princeton.edu/~pbolton/BBRPrincetonDP.pdf, subsequently published in the Georgetown Law Journal, Vol. 88, No. 8, August 2000, at 2239-2330.

Bolton explains the effect of "reputation effect predation" on both current and future competitive entry. Carlton's claim that predation is irrational is based upon the notion that predation always involves shifting profits from the present to the future, *i.e.*, that the predation strategy will need to be funded by the potential future profits that would presumably be realized once the existing competitors are forced to exit the market. However, as Bolton points out (and as Dr. Selwyn has also noted in his declaration), a predation strategy can also be funded by shifting profits from competitive segments of the multi-product firm to monopoly segments – *i.e.*, funded out of *present* rather than future monopoly profits. Additionally, Bolton notes that predation can also work to *deter entry* even before it arrives – so-called "reputation effect predation." Importantly, Bolton notes that this predatory pricing scheme can be supported *either* by the expectation of future earnings *or* through monopoly profits generated by other products offered by a multi-market firm. By signaling a willingness to forego profits to drive out competitors, the predators harm a competitor's access to the necessary capital to enter the market.